REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

THIRD DIVISION

MEDTECS INTERNATIONAL CORPORATION LIMITED,
Petitioner,

-versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CTA Case No. 8538

Members:
BAUTISTA, Chairperson
FABON-VICTORINO, *and*
RINGPIS-LIBAN, *JJ.*

Promulgated:

NOV 04 2015
3:35 p.m.

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DECISION

RINGPIS-LIBAN, *J.*:

This Petition for Review filed by Medtecs International Corporation Limited seeks the reversal of the Final Decision on Disputed Assessment dated July 23, 2012 that found it liable for alleged deficiency income tax, value-added tax (VAT), expanded withholding tax (EWT), withholding tax on compensation (WTC), and documentary stamp tax (DST) in the total amount of Ten Million Four Hundred Ninety-Eight Thousand Seven Hundred Seventy-Three and 51/100 Pesos (₱10,498,773.51) for taxable year 2006.

STATEMENT OF FACTS

Petitioner Medtecs International Corporation Limited is the Philippine Branch of Medtecs International Corporation Limited (Bermuda), duly registered with the Securities and Exchange Commission on July 6, 1998. Its principal office address is at 7th Street, Phase II, Bataan Processing Zone, Mariveles, Bataan.[1] Petitioner is also registered with the Philippine Economic

[1] Par. I(a), Joint Stipulation of Facts and Issues (JSFI), *Docket*, p. 772; Exhibits "G" and "H", *Docket*, pp. 1088 to 1092 and 1093 to 1095, respectively.

Zone Authority (PEZA) as an ECOZONE Export Enterprise at the Bataan Economic Zone.[2]

Respondent is the duly appointed Commissioner of the Bureau of Internal Revenue (BIR), vested with power to decide administrative tax cases, including disputed assessments. She holds office at the BIR National Office Building, Agham Road, Diliman, Quezon City.

On December 3, 2007, Letter of Authority (LOA) No. LOA 2001 00074246[3] was issued authorizing Revenue District Officer (RDO) Roel Vergel Narag to examine petitioner's books of accounts and other accounting records for all internal revenue taxes covering the period of January 1, 2006 to December 31, 2006.[4] Respondent thus asked petitioner to present the latter's records for the subject period.[5]

Thereafter, respondent sent to petitioner a Notice for Informal Conference (NIC) dated September 23, 2008, which petitioner received on September 25, 2008, containing a recommendation for possible assessment of deficiency tax liabilities for taxable year 2006.[6] The Informal Conference on the results of the investigation pursuant to the LOA was not held.

On March 16, 2009, the Notice for Informal Conference was amended pursuant to a Memorandum dated January 22, 2009 stating, among others, that petitioner has not signified any formal intention regarding the matter. The amended NIC was received by petitioner on April 14, 2009.[7]

On May 6, 2009, the petitioner sent a letter stating its position on the preliminary findings of the RDO. Respondent sent a Reply which was received by petitioner on November 24, 2009, stating among others that petitioner failed to attach supporting documents to support its position.

On May 28, 2009, respondent notified petitioner of the reassignment to another revenue officer of the investigation of petitioner's tax case.[8] Likewise, respondent informed petitioner on July 21, 2009 that upon pre-audit/investigation, it was found out that the latter had deficiency taxes for taxable year 2006.[9]

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[2] Exhibit "Q", *Docket*, p. 1337.
[3] Exhibit "1", BIR records, p. 41.
[4] Par. I(c), JSFI, *Docket*, p. 772.
[5] Exhibit "2", BIR records, p. 40.
[6] Exhibit "3", BIR records, pp. 320 to 323.
[7] Exhibit "4", BIR records, pp. 343 to 346.
[8] Exhibit "5", BIR records, p. 348.
[9] Exhibit "6", BIR records, p. 355.

On July 28, 2011, a recommendation for the issuance of a Preliminary Assessment Notice (PAN) against petitioner was made.[10]

Consequently, respondent issued a PAN[11] dated August 18, 2011 with Details of Discrepancies, assessing petitioner for deficiency income tax, VAT, EWT, WTC, and DST for taxable year 2006 in the aggregate amount of ₱10,050,587.02.[12]

On September 23, 2011, petitioner filed its protest[13] against the PAN.[14] Petitioner's protest was given due course and a re-investigation was granted by the Regional Director pursuant to a Memorandum dated September 30, 2011.

Subsequently, respondent issued a Formal Letter of Demand and Audit Results/Assessment Notices[15] dated February 28, 2012 with Details of Discrepancies,[16] assessing petitioner of the following alleged deficiency taxes:

Deficiency Income Tax	35%	5%
Taxable net income per audit	₱6,788,883.00	₱15,066,367.46
Income tax due	2,376,109.05	753,318.37
Total income tax		3,129,427.42
Less: Tax paid		1,084,034.00
Balance		2,045,393.42
20% Interest p.a.		2,147,663.09
TOTAL AMOUNT DUE & COLLECTIBLE		₱4,193,056.52
Deficiency VAT		
Taxable receipts per audit		6,962,983.33
VAT due		835,558.00
25% Surcharge		208,889.50
20% Interest p.a.		919,113.80
TOTAL AMOUNT DUE & COLLECTIBLE		₱1,963,561.30
Deficiency Expanded Withholding Tax		
Expanded withholding tax due		279,168.59
Less: Remittance		274,964.86
Balance		4,203.73
20% Interest p.a.		4,624.10
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 8,827.83
Deficiency Withholding Tax on Compensation		
Withholding tax due on compensation		3,024,551.55
Less: Remittance		2,827,501.45
Balance		197,050.10

[10] Exhibit "7", BIR records, pp. 382 to 383.
[11] Exhibit "A", *Docket*, pp. 38 to 47; Exhibit "8", BIR records, pp. 401 to 403.
[12] Par. I(d), JSFI, *Docket*, p. 773.
[13] Exhibit "B", *Docket*, pp. 1069 to 1077.
[14] Par. I(e), JSFI, *Docket* t, p. 773.
[15] Exhibit "C", *Docket*, pp. 57 to 66; Exhibits "12" to "12-g", BIR records, pp. 456 to 472.
[16] Par. I(f), JSFI, *Docket*, p. 773.

20% Interest p.a.		222,009.78
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 419,059.88
Deficiency Documentary Stamp Tax		
Documentary Stamp Tax		1,596,709.78
25% Surcharge		399,177.45
20% Interest p.a.		1,756,380.76
TOTAL AMOUNT DUE & COLLECTIBLE		₱3,752,267.98
Compromise Penalty (RMO 19-2007)		
Compromise penalty on deficiency income tax		50,000.00
Compromise penalty on deficiency VAT		20,000.00
Compromise penalty on deficiency expanded withholding tax		1,000.00
Compromise penalty on deficiency withholding tax on compensation		16,000.00
Compromise penalty on deficiency documentary stamp tax		75,000.00
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 162,000.00

On April 10, 2012, petitioner protested the Formal Letter of Demand.[17] Then, petitioner submitted its documents in support of its administrative protests against the Formal Letter of Demand on June 7, 2012.[18]

On July 23, 2012,[19] respondent issued the Final Decision on Disputed Assessment[20] that denied petitioner's protest; prompting petitioner to file the instant Petition for Review[21] before this Court on August 30, 2012.

In the Answer[22] filed on October 31, 2012, respondent interposed her special and affirmative defenses, as follows:

First, the Court has no jurisdiction over the Petition for Review. The Petition was prematurely filed because the August 1, 2012 Letter Decision denying its administrative protest allegedly received by petitioner was unsubstantiated. The alleged Letter-Decision quoted in the Petition was merely encoded, hence, self-serving, and Annex "F" is a mere certified machine copy which proves neither service nor receipt, contrary to Section 228 of the Tax Code, as amended.

Moreover, Revenue Regulations (RR) No. 12-99, particularly Section 3.1.5, mandates that a taxpayer may protest administratively against the formal letter of demand and the assessment notice within thirty (30) days from receipt

[17] Par. I(g), JSFI, *Docket*, p. 773; Exhibit "D", docket, pp. 1078 to 1086.
[18] Par. I(h), JSFI, *Docket*, p. 773; Exhibit "E", docket, p. 1087.
[19] Par. I(i), JSFI, *Docket*, p. 773.
[20] Exhibit "F", *Docket*, p. 77.
[21] *Docket*, pp. 6 to 34.
[22] *Id*, pp. 706 to 738.

thereof, otherwise the assessment shall become final, executory and demandable.

Since petitioner failed to proffer evidence of receipt of the alleged Letter-Decision, it follows that no receipt of such occured and that no Final Decision on Disputed Assessment (FDDA) was issued. Hence, respondent claims that the Petition is premature and the thirty (30)-day period within which to elevate a disputed assessment is inapplicable. This means that the taxpayer must wait for the inaction of respondent or the lapse of 180 days before the Court acquires jurisdiction over the same.

Petitioner filed its protest on the Formal Letter of Demand (FLD) on April 10, 2012 and submitted documents supporting its protest on June 7, 2012. Petitioner then elevated the case to the CTA on August 30, 2012 or only 84 days from the submission of its supporting documents. Hence, the Court never acquired jurisdiction over this case.

Second, respondent observed Due Process during the assessment of petitioner. Contrary to petitioner's claims, respondent gave petitioner every chance to support its claim.

When petitioner filed its protest to the PAN on September 23, 2011, the protest was given due course and re-investigation granted by the Regional Director pursuant to a Memorandum dated September 30, 2011.

As per memorandum of assignment No. MOA-20-0003-12 dated January 2, 2012, the case docket was referred to RO Pacita D. Macandili for reinvestigation per protest letter/request for reinvestigation filed by petitioner.

A Re-Assignment Notice was sent to petitioner on January 17, 2012, informing petitioner's representative of the presentation of relevant supporting documents relative to its claim. However, petitioner still failed to submit additional/relevant documents during its re-investigation.

Respondent proffers that it was a result of petitioner's persistent inaction and lack of interest despite due notice that an FLD was issued on February 28, 2012 against petitioner. A protest was immediately filed by petitioner on April 4, 2012.[23] *(sic)*

On April 27, 2012, the Regional Director sent a letter addressing the protest of the petitioner on the FLD. Yet, it was only on June 7, 2012 that petitioner submitted its documents to support its claim.

[23] Records show that the Protest to the FLD was filed by petitioner on April 10, 2014.

The foregoing tax assessment issued to petitioner was also accompanied by an Audit Result & Assessment stating thereon the details of discrepancy which contained the facts, the applicable laws, rules and regulations, or jurisprudence on which such decision was made.

From the foregoing, it is clear that petitioner was given every opportunity to support its claims.

Third, as required by Section 228 of the Tax Code and RR No. 12-99, petitioner was informed of the legal and factual bases of the assessment issued against it. Petitioner's deficiency tax liabilities were detailed in the corresponding notices in the FLD, the Details of Discrepancy and attached Annexes, all of which reflected the facts, laws, rules and regulations or jurisprudence on which the assessment was based.

Fourth, petitioner is liable for deficiency income tax for taxable year 2006.

For purposes of computing the total 5% tax rate imposed by RA 7916, the cost of sales or direct cost shall consist only of the cost or expense items specified in the RR 11-2005. Petitioner posits, however, that transportation, communication and office supplies expense are part of the cost of inventory which are deductible expenses for purposes of computing the 5% Gross Income Tax, relying on Section 7 of RR 2-2005 which provides for the deductible expenses for PEZA registered entities.

Under RR 11-2005[24], defining 'Gross Income Earned' to implement the Tax Incentive Provision in Section 24 of The Special Economic Zone Act of 1995[25], intermediate goods or producer goods or semi-finished products are goods used as inputs in the production of other goods, such as partly finished goods. Also, they are goods used in production of final goods. A firm may make then use intermediate goods, or make then sell, or buy then use them.

Necessarily, Transportation, Communication and Office Supplies Expenses do not form part of "decrease in goods in process account" (intermediate goods) or "decrease in finished goods account" and, consequently, should not be included as part of the cost of inventory. In the production process, intermediate goods either become part of the final product, or are changed beyond recognition in the process.

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[24] This revoked Section 7 of Revenue Regulations No. 2-2005 and suspended the effectivity of certain provisions thereof.
[25] Republic Act No. 7916.

On the other hand, Rent Income, Insurance Claims & Gains from Insurance Claims are classified as Other Income and are subject to regular corporate tax rate of 35% pursuant to Sec. 27 of the Tax Code and RR 20-2002.

While Rent Income was not raised by petitioner as an issue, petitioner mistakenly claims that Insurance Claim and Gain from Insurance are subject to the 5% Gross Income Tax.

The money received from an insurance company for a claim involving a loss on inventory stock is debited to Cash, and any other proceeds from disposing of the inventory items will also be debited to Cash. In addition, the Inventory account is credited for the carrying cost of the inventory items, which is usually the original cost of the items. If the total of the debits to Cash is greater than the credits to Inventory, the difference is credited to a gain account, such as Gain from Inventory Damage. If the total of the debits to Cash is less than the credits to Inventory, the difference is a debit to a loss account, such as Loss from Inventory Damage.

Clearly, a gain from insurance was correctly denominated as Other Income, hence, is subject to the 35% regular corporate tax pursuant to RR 16-2005 and Section 2(nn) of Rule I of the PEZA Rules[26].

Fifth, petitioner is liable for deficiency VAT for taxable year 2006 as Other Operating Income and Miscellaneous Income are subject to VAT at the rate of 12%, pursuant to Section 105 of the Tax Code.

Insurance Claims, Canteen Rental and Miscellaneous Income as assessed by respondent are clearly within the definition of gross revenues derived from unregistered activities of herein petitioner under Section 2(nn) of Rule I of the PEZA Rules.

As an ordinary corporate taxpayer, petitioner is liable for payment of VAT on its income from unregistered activities pursuant to the provisions of RR 16-2005 which enjoys the presumption of validity.

Sixth, Petitioner is liable for the assessed deficiency Expanded Withholding Tax (EWT) as Repairs and Maintenance, Advertising, Documentation and Handling Expenses of ₱212,378.59; ₱26,687.73; and ₱27,780.00, respectively, should be subject to EWT in accordance with Section 57 of the Tax Code and Section 2.57.1 of RR 2-98.

[26] Rules and Regulations to Implement Republic Act No. 7916, otherwise known as the Special Economic Zone Act of 1995.

Necessarily, repairs and maintenance, on its face, form part of EWT as they are income payments. Petitioner has not substantiated, even in its supposed supporting documents, its contention that repairs were done by its employees and that the amounts disbursed represented the cost of building materials and machinery parts.

Also, Advertising, Documentation and Handling Expenses form part of income payments which are subject to withholding tax.

Seventh, corollary to the above finding, petitioner is also liable for the assessed deficiency Withholding Tax on Compensation (WTC) on salaries and wages in the amount of ₱3,914,001.91, in accordance with Section 78 and 79 of the Tax Code as implemented by RR 2-98.

Eighth, Petitioner is liable for the assessed deficiency Documentary Stamp Tax (DST) contrary to its claim that it is exempted from paying it due to its 5% preferential tax rate in lieu of all taxes.

Pursuant to Section 173 of the Tax Code which imposes the collection of DST on documents, instruments, loan agreements and papers to the person making, signing, accepting or transferring the same, whenever one party to the taxable document enjoys exemption from the tax, the other party who is not exempt shall be the one liable for the tax.

Necessarily, stock options were assessed pursuant to Section 174 of the Tax Code, and the lease contract was assessed based on Section 194 thereof as well.

Finally, citing the case of *Rizal Commercial Banking Corporation vs. Commissioner of Internal Revenue*[27], respondent avers that all presumptions are in favor of the correctness of tax assessments. Dereliction on the part of petitioner to satisfactorily overcome the presumption of regularity and correctness of the tax assessment will justify the judicial upholding of said assessment notices.

The Pre-Trial Brief (For Petitioner)[28] was filed on November 23, 2012; while respondent's Pre-Trial Brief[29] was filed on November 26, 2012.

The parties submitted their Joint Stipulation of Facts and Issues[30] on December 12, 2012. Afterwards, the Court issued the Pre-Trial Order[31] on January 2, 2013.

[27] G.R. No. 168498, April 24, 2007.
[28] *Docket*, pp. 743 to 754.
[29] *Id.*, pp. 755 to 764.

During trial, petitioner presented its sole witness Wilson Pastelero. On the other hand, respondent presented Revenue Officers Roel Vergel G. Narag, Mary Ann T. Villasol-Canare, and Pacita D. Macandili as her witnesses.

Thereafter, the parties formally offered their respective documentary and testimonial evidence.

The instant case was submitted for decision on November 6, 2014, after petitioner filed its Memorandum (For Petitioner)[32] on September 3, 2014 and respondent filed her Memorandum[33] on October 30, 2014.[34]

STATEMENT OF ISSUES

The parties submitted the following issues[35] for this Court's resolution:

1. Whether or not due process was observed in assessing petitioner for deficiency taxes under the Tax Code and Revenue Regulations No. 12-99; and

2. Whether or not petitioner is liable for deficiency income tax, VAT, EWT, withholding tax on compensation and DST for taxable year 2006 in the aggregate amount of ₱10,498,773.51.

The above-enumerated issues can be summarized as follows:

"Whether or not petitioner is liable for deficiency income tax, VAT, EWT, WTC, and DST for taxable year 2006 in the aggregate amount of ₱10,498,773.51."

DISCUSSION/RULING

As regards the jurisdiction of the Court over the present case, Section 228 of the Tax Code, as amended, provides:

> "SEC. 228. *Protesting of Assessment.* – When the Commissioner or his duly authorized representative finds that

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[30] *Id.*, pp. 772 to 774.
[31] *Id.*, pp. 776 to 787.
[32] *Id.*, pp. 1515 to 1541.
[33] *Id.*, pp. 1549 to 1560.
[34] Resolution, *Docket*, p. 1563.
[35] *Docket*, p. 773.

> proper taxes should be assessed, he shall first notify the taxpayer of his findings: *Provided, however*, That a preassessment notice shall not be required in the following cases:
>
> xxx xxx xxx
>
> The taxpayers shall be informed in writing of the law and the facts on which the assessment is made; otherwise, the assessment shall be void.
>
> Within a period to be prescribed by implementing rules and regulations, the taxpayer shall be required to respond to said notice. If the taxpayer fails to respond, the Commissioner or his duly authorized representative shall issue an assessment based on his findings.
>
> Such assessment may be protested administratively by filing a request for reconsideration or reinvestigation within thirty (30) days from receipt of the assessment in such form and manner as may be prescribed by implementing rules and regulations. Within sixty (60) days from filing of the protest, all relevant supporting documents shall have been submitted; otherwise, the assessment shall become final.
>
> If the protest is denied in whole or in part, or is not acted upon within one hundred eighty (180) days from submission of documents, the taxpayer adversely affected by the decision or inaction may appeal to the Court of Tax Appeals within thirty (30) days from receipt of the said decision, or from the lapse of the one hundred eighty (180)-day period; otherwise, the decision shall become final, executory and demandable."

Records show that respondent issued the FLD with Details of Discrepancies and the FAN on February 28, 2012,[36] which petitioner received on March 9, 2012[37]. Petitioner had thirty (30) days from March 9, 2012 or until April 8, 2012 within which to administratively protest the said assessment.

Considering that April 8, 2012 fell on a Sunday and April 9, 2012 was a regular holiday, petitioner filed its Protest Letter to the FAN on the next working day, which was on April 10, 2012.[38] This means that petitioner had sixty (60) days within which to submit its supporting documents in relation to the protest, which petitioner did on June 7, 2012.[39]

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[36] Exhibit "C", *Docket*, pp. 57 to 66; Exhibits "12" to "12-g", BIR records, pp. 456 to 472.
[37] Petition for Review, *Docket*, p. 8.
[38] Exhibit "D", *Docket*, pp. 1078 to 1086.
[39] Exhibit "E", *Docket*, p. 1087.

On July 23, 2012, respondent issued the FDDA[40], which petitioner received on August 1, 2012[41]. Accordingly, petitioner had thirty (30) days from August 1, 2012 or until August 31, 2012 to appeal the adverse decision of respondent.

Since petitioner filed the instant Petition for Review on August 30, 2012[42], the Petition was timely filed and the Court has jurisdiction over this case.

As regards petitioner's liability for the assessed deficiency income tax, VAT, EWT, WTC, and DST in the total amount of ₱10,498,773.51, inclusive of surcharges, interests and compromise penalties for taxable year 2006 were broken down as follows:[43]

Deficiency Tax	Basic	Surcharge	Interest	Compromise Penalty	Total
Income Tax	₱ 2,045,393.42	-	₱ 2,147,663.09	₱ 50,000.00	₱ 4,243,056.51
Value-added Tax	835,558.00	₱ 208,889.50	919,113.80	20,000.00	1,983,561.30
Expanded Withholding Tax	4,203.73	-	4,624.10	1,000.00	9,827.83
Withholding Tax on Compensation	197,050.10	-	222,009.78	16,000.00	435,059.88
Documentary Stamp Tax	1,596,709.78	399,177.45	1,756,380.76	75,000.00	3,827,267.99
TOTAL	**₱4,678,915.03**	**₱608,066.95**	**₱5,049,791.53**	**₱162,000.00**	**₱10,498,773.51**

I. Deficiency Income Tax (₱4,193,056.52)

For taxable year 2006, respondent found petitioner liable for deficiency income tax in the amount of ₱4,193,056.52, inclusive of interest, the detailed computation of which is reproduced hereunder:[44]

Deficiency Income Tax	**35%**	**5%**
Taxable net income per audit	₱6,788,883.00	₱ 15,066,367.46
Income Tax due	2,376,109.05	753,318.37
Total Income Tax due		3,129,427.42
Less: Tax paid		1,084,034.00
Balance		**2,045,393.42**
20% interest p.a.		2,147,663.09
TOTAL AMOUNT DUE AND COLLECTIBLE		**₱4,193,056.52**[45]

[40] Exhibit "F", *Docket*, p. 77.
[41] Petition for Review, *Docket*, p. 9.
[42] *Docket*, p. 6.
[43] Exhibit "C", *Docket*, pp. 57 to 66; Exhibit "12", BIR records, pp. 456 to 461 and 463 to 472.
[44] Exhibit "C", *Docket*, p. 57; Exhibit "12", BIR records, p. 472.
[45] Should be ₱4,193,056.51.

The basic deficiency income tax assessment of ₱2,045,393.42 arose from respondent's disallowance of petitioner's claimed cost of sales, specifically factory overhead (FO), in the amount of ₱174,568.46 and the disallowance of other income in the amount of ₱6,788,883.00 from being subjected to 5% gross income tax (GIT). A more detailed computation found in Annex "C" of the FLD is shown below:[46]

Taxable Income per Return		**₱21,680,682.00**
Add: Adjustments		
FO-Repairs	-	
FO-Insurance	-	
FO-Transportation	₱ 10,301.00	
FO-Communication	93,445.06	
FO-Supplies	70,822.40	174,568.46
		21,855,250.46
Rent Income	₱ (120,000.00)	
Insurance claims	(30,000.00)	
Gains from Insurance claims	(6,638,883.00)	(6,788,883.00)
Taxable Income (5%)		15,066,367.46
Other Operating Income taxed at 35%		
Other Operating Income	₱ 150,000.00	
Gains from Insurance Claims	6,638,883.00	
Interest Income-Affiliates	-	
Rent Income	-	
Miscellaneous Income	-	
Taxable Income at 35%		6,788,883.00
Tax due at 5%		753,318.37
Tax due at 35%		2,376,109.05
Total		3,129,427.42
Less: Paid		1,084,034.00
Balance		**₱2,045,393.42**

The findings of the Court as regards the propriety of the composition of the deficiency income tax assessment are as follows:

A. Disallowed Deductions (₱174,568.46)

Respondent's investigation disclosed that some of petitioner's claimed deductions for factory overhead, namely, FO-Transportation, FO-

[46] Exhibit "C", *Docket*, p. 61; Exhibit "12", BIR records, p. 468.

Communication and FO-Supplies amounting to ₱10,301.00, ₱93,445.06 and ₱70,822.40, respectively, were disallowed deductions pursuant to RA 7916, as implemented by RR 02-2005 and RR 11-2005.[47]

Petitioner, on the other hand, claims that transportation expenses were incurred by factory personnel and were charged to cost of goods manufactured since the activity was related and directly attributable to petitioner's production of goods.

With regard to communication expense, petitioner argues that factory telephone units were installed and the cost thereof was part of production since the activity was directly related to the operations of petitioner's manufacturing plant. Further, the users of the said telephone units were factory engineers, factory supervisors and their assistants. Thus, the cost for using the telephone units was part of the cost of inventory.

According to petitioner, the office supplies were used in the production area so the cost was charged as part of the factory overhead, which was likewise part of the inventory.

The Court finds the disallowance proper.

One of the incentives available to ECOZONE Export Enterprises is the imposition of preferential tax rate of five percent (5%) on gross income earned as provided under Section 24 of RA 7916, otherwise known as "The Special Economic Zone Act of 1995" (PEZA Law), as amended by RA 8748, which states:

> "SECTION 24. *Exemption from National and Local Taxes.* – Except for real property taxes on land owned by developers, no taxes, local and national, shall be imposed on business establishments operating within the ECOZONE. In lieu thereof, five percent (5%) of the gross income earned by all business enterprises within the ECOZONE shall be paid and remitted as follows:
>
> (a) Three percent (3%) to the National Government;
>
> (b) Two percent (2%) which shall be directly remitted by the business establishments to the treasurer's office of the municipality or city where the enterprise is located."

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[47] Exhibit "C", *Docket*, p. 59; Exhibit "12", BIR records, p. 470.

"Gross Income" has been defined in Section 2(nn) of Rule I of the PEZA Rules in the following manner:

> "nn. *'Gross Income'* for purposes of computing the special tax due under Section 24 of the Act refers to gross sales or gross revenues derived from business activity within the ECOZONE, net of sales discounts, sales returns and allowances and minus costs of sales or direct costs but before any deduction is made for administrative expenses or incidental losses during a given taxable period. The allowable deductions from 'gross income' are specifically enumerated under Section 2, Rule XX of these Rules."

In this regard, Section 4 of Rule XX of the PEZA Rules enumerates the allowable deductions from gross income for specific types of ECOZONE Export Enterprise, *viz:*

> "SECTION 4. *Gross Income Earned; Allowable Deductions.* – For purposes of these Rules, Gross Income earned shall be defined in Section 2(nn), Rule I of these Rules, subject to the following allowable deductions for specific types of enterprises:
>
> 1. ECOZONE Export Enterprises, Free Trade Enterprises and Domestic Market Enterprises
>
> — Direct salaries, wages or labor expenses
> — Production supervision salaries
> — Raw materials used in the manufacture of products
> — Goods in Process (intermediate goods)
> — Finished goods
> — Supplies and fuels used in production
> — Depreciation of machinery and equipment used in production and buildings owned or constructed by an ECOZONE Enterprise
> — Rent and utility charges associated with building, equipment and warehouses, or handling of goods
> — Financing charges associated with fixed assets"

To further implement the provisions of Section 24 of RA 7916, the BIR issued RR 02-2005, as amended by RR 11-2005, the pertinent portion of which is quoted hereunder:

> "For purposes of computing the total five percent (5%) tax rate imposed, the following direct costs are included in the

allowable deductions to arrive at gross income earned for specific types of enterprises:

1. ECOZONE Export Enterprises, Free Trade Enterprises and Domestic Market Enterprises:

— Direct salaries, wages or labor expenses
— Production supervision salaries
— Raw materials used in the manufacture of products
— Decrease in Goods in Process Account (Intermediate goods)
— Decrease in Finished Goods Account
— Supplies and fuels used in production
— Depreciation of machinery and equipment used in production, and of that portion of the building owned or constructed that is used exclusively in the production of goods
— Rent and utility charges associated with building, equipment and warehouses used in production
— Financing charges associated with fixed assets used in production the amount of which were not previously capitalized"

It is apparent from the afore-quoted provision of RR 11-2005 that those enumerated expenses considered as direct costs or cost of sale, are not exclusive. Accordingly, expenses which are in the nature of direct costs, although not mentioned in the said provision, may be considered as allowable deductions.

Further, for expenses to be allowed as deductions, they should be part of direct costs attributable to the PEZA-registered activity.

It is also noteworthy that Section 27(a) of the Tax Code, defines the terms "gross income" and "cost of goods sold", in the following manner:

"SEC. 27. *Rates of Income Tax on Domestic Corporations.* –

xxx xxx xxx

For purposes of this Section, the term **'gross income'** derived from business shall be equivalent to gross sales less sales returns, discounts and allowances and cost of goods sold. **'Cost of goods sold'** shall include all business expenses directly incurred to produce the merchandise to bring them to their present location and use.

xxx xxx xxx

For a manufacturing concern, **'cost of goods manufactured and sold' shall include all costs of production of finished goods, such as raw materials used, direct labor and manufacturing overhead, freight cost, insurance premiums, and other costs incurred to bring the raw materials to the factory or warehouse.**" *(Emphasis supplied)*

In other words, other costs aside from direct cost can be categorized as operating expenses.

Operating expenses are defined as primary recurring costs associated with central operations, other than cost of goods sold, which are incurred to generate sales. They are normally classified into the following two categories:

a. Distribution costs (or selling expenses); and
b. General and administrative expenses.

Distribution costs are those expenses related directly to the company's efforts to generate sales (*e.g.*, sales salaries, commissions, advertising, delivery expenses, depreciation of store furniture and equipment, and store supplies). General and administrative expenses are expenses related to the general administration of the company's operations (*e.g.*, officers and office salaries, office supplies, depreciation of office furniture and fixtures, telephone, postage, accounting and legal services, and business licenses and fees).[48]

Based on the above provisions, for purposes of computing the 5% preferential tax, gross sales/revenues may be reduced only by sales discounts, sales returns and allowances, cost of sales or direct costs or any of the enumerated allowable deductions under RR 11-2005. Hence, in determining whether a cost is part of cost of goods manufactured and sold, particularly factory overhead, said cost must be attributable to the PEZA-registered products or goods of petitioner.

The International Accounting Standard (IAS) 2, *Inventories* provides that the "cost of inventories shall comprise all costs of purchase, costs of

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[48] *Wiley IFRS 2013 Interpretation and Application of Internaltional Accounting and Finacial Reporting Standards*, John Wiley & Sons, Inc., p. 112.

conversion and other costs incurred in bringing the inventories to their present location and condition".[49]

Corollary hereto, "Costs of Conversion" is defined as follows:

> "12. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour."[50]

Following this, it is necessary for petitioner to prove that the FO-Transportation, FO-Communication and FO-Office Supplies are costs that may justifiably be allocated as production overheads incurred in the conversion of materials into finished goods.

Petitioner presented its Certificate of Incorporation[51] with the Securities and Exchange Commission (SEC), showing the establishment of petitioner as a branch office of its foreign corporation Head Office. The said Certificate of Incorporation proves that petitioner is licensed to transact business in the Philippines and to perform the following business activities:

(a) Wholesale marketing, distributorship, packaging, design and manufacture of medical supplies, medical textile and similar items, house linens, garments and its accessories, by-products, etc., through spinning and/or weaving (conventional or through water-jet), knitting and/or finishing and/or printing and sewing process;
(b) Wholesale marketing, distributorship and manufacturing of medical equipment and accessories; and
(c) Buying, selling on a wholesale basis only, hiring, letting and dealing in conveyances of any sort.

[49] Philippine Financial Reporting Standards (PFRSs), Philippine Institute of Certified Public Accountants (PICPA), Part I of II, p. 434.
[50] *Id.*, p. 435.
[51] Exhibit "G", *Docket*, p. 1088.

However, since petitioner failed to present the Terms and Conditions of its PEZA Registration Agreement, the Court cannot ascertain which of the aforementioned business activities are actually registered with the PEZA.

Furthermore, in support of its allegations, petitioner submitted Exhibits "K" to "K-23"[52], consisting of Accounts Payable (AP) vouchers, Liquidation Sheets, Material Receiving Reports, and Official Receipts from various suppliers. Petitioner asserts that these documents supported the deductibility of transportation, communication and office supplies.

The details of the said exhibits are as follows:

A) FO-Transportation Expense (₱10,301.00)

Exh. No.	Description	Amount
"K"	Payment for transportation and representation expense as per attached liquidation	1,100.00
	FO - Transportation Expense per assessment	(10,301.00)
	Unsubstantiated amount	**(9,201.00)**

B) FO-Communication Expense (₱93,445.06)

Exh. No.	Description	Amount
"K-1"	Payment for telephone/communication expenses for the month of January 2006 as per attached billing	7,555.63
	FO - Communication per assessment	(93,445.06)
	Unsubstantiated amount	**(85,889.43)**

C) FO-Office Supplies Expense (₱86,107.90)[53]

Exh. No.	Description	Amount
"K-2"	Payment for office supplies as per attached summary	8,602.25
"K-3"	Payment for toner refill	4,800.00
"K-4"	Payment for office supplies as per attached summary	5,865.50
"K-5"	Payment for office supplies as per attached summary	4,260.90
"K-6"	Payment for HP toner	3,400.00
"K-7"	Payment for toner	1,200.00
"K-8"	Payment for office supplies as per attached summary	6,089.60
"K-9"	Payment for printing of various personnel dept. forms	1,520.00
"K-10"	Payment for timecards	900.00
"K-11"	Payment for 1 unit standard terminator wallfan 16"	1,150.00
"K-12"	Payment for office supplies as per attached summary	7,013.00
"K-13"	Payment for HP toner	6,600.00
"K-14"	Payment for film roller as replacement for HP 1015 printer	3,000.00
"K-15"[54]	Payment for toner refill	1,200.00

[52] *Docket*, pp. 1130 to 1184.
[53] The assessed amount for FO-Office Supplies Expense is only ₱70,822.40.
[54] Denied per Resolution dated March 20, 2013, docket, p. 1342.

"K-16"	Payment for office supplies as per attached summary	1,967.70
"K-17"	Payment for office supplies as per attached summary	1,911.30
"K-18"	Payment for toner-original	3,300.00
"K-19"	Payment for office supplies as per attached summary	1,165.75
"K-20"	Payment for printer toner	3,300.00
"K-21"	Payment for office supplies as per attached summary	2,121.90
"K-22"	Payment for printer toner	3,500.00
"K-23"	Payment for office supplies as per attached summary	13,240.00
	TOTAL	**86,107.90**
	FO - OFFICE SUPPLIES EXPENSE per assessment	**(70,822.40)**
		No unsubstantiated amount

The breakdown is presented in such a manner as to show the portion of the assessed expenses for which there was no evidence presented by petitioner. Consequently, petitioner failed to substantiate the FO-Transportation expense in the amount of ₱9,201.00 and FO-Communication expense in the amount of ₱85,889.43; thus, they are denied as allowable deductions.

As far as the amounts that were substantiated, petitioner provided Accounts Payable vouchers accompanied by official receipts from suppliers. However, these pieces of evidence only proved actual payment, but did not establish the connection of these costs to its registered activities.

Since it cannot be ascertained which of petitioner's business activities are actually registered with the PEZA, the Court likewise cannot determine if the above-mentioned expenses incurred by petitioner were directly attributable to the latter's PEZA-registered activies.

Accordingly, the deficiency income tax assessment on petitioner's FO-Transportation, FO-Communication and FO-Office Supplies expenses in the total amount of ₱174,568.46 should be upheld.

B. Disallowed Income under 5% Gross Income Tax (₱6,788,883.00)

Since the disallowed income in the amount of ₱6,788,883.00 is one of the items under the deficiency VAT assessment, the discussion of the same shall extend to the deficiency VAT assessment.

Respondent classified rent income, insurance claims and gain from insurance claims as Other Income amounting to ₱120,000.00, ₱30,000.00 and ₱6,638,883.00, respectively, totalling ₱6,788,883.00, and subjected the same to regular corporate income tax rate of 35% in accordance with Section 27 of the Tax Code and RR 20-2002.

Respondent likewise imposed VAT on the said rent income, insurance claims and gain from insurance claims, citing Section 108 of the Tax Code.

Section 27 of the Tax Code and Section 1 of RR 20-2002 provide:

> "SEC. 27. *Rates of Income Tax on Domestic Corporations.* –
>
> (A) *In General.* – Except as otherwise provided in this Code, an income tax of thirty-five percent (35%) is hereby imposed upon the taxable income derived during each taxable year from all sources within and without the Philippines by every corporation, as defined in Section 22(B) of this Code and taxable under this Title as a corporation, organized in, or existing under the laws of the Philippines: *Provided,* That effective January 1, 2009, the rate of income tax shall be thirty percent (30%)."
>
> "SECTION 1. *Tax Treatment.* – Income derived by an enterprise registered with the Subic Bay Metropolitan Authority (SBMA), the Clark Development Authority (CDA), or the Philippine Economic Zone Authority (PEZA) from its registered activity/ies shall be subject to such tax treatment as may be specified in its terms of registration (*i.e.*, the 5% preferential tax rate, the income tax holiday, or the regular income tax rate, as the case may be). **Nonetheless, whatever the tax treatment of said enterprise with respect to its registered activity/ies, income realized by such registered enterprise that is not related to its registered activity/ies shall be subject to the regular internal revenue taxes**, such as the 20% final income tax on interest from Philippine Currency bank deposits and yield or any other monetary benefit from deposit substitutes, and from trust funds and similar arrangements, the 7.5% tax on foreign currency deposits and the 5%/10% capital gains tax or ½% stock transaction tax, as the case may be, on the sale of shares of stock." *(Emphasis supplied)*

The Court shall resolve first the deficiency income tax and VAT assessments on the rent income of ₱120,000.00.

Respondent alleges in her Answer[55] that petitioner did not raise rent income as an issue. And records reveal that petitioner did not assail the assessment on rent income administratively or judicially.

Well-settled is the rule that tax assessments by tax examiners are presumed correct and made in good faith, and all presumptions are in favor of

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[55] *Docket*, p. 726.

the correctness of a tax assessment unless proven otherwise.[56] And since petitioner failed to present any proof establishing its PEZA-registered activities, the Court is unable to determine if rental income was earned from petitioner's registered activities. For lack of proof to the contrary and for petitioner's failure to dispute the assessment on rent income, the same should be subject to 35% deficiency income tax pursuant to Section 27(a) in relation to Section 32(a)(5) of the Tax Code and 12% deficiency VAT pursuant to Section 108(a) of the same Code.

Proceeding to the determination of whether or not petitioner is liable for 35% deficiency income tax and 12% deficiency VAT on the insurance claim in the amount of ₱30,000.00 and gain from insurance claims in the amount of ₱6,638,883.00, the Court observes that petitioner made conflicting contentions thereon.

In assailing the deficiency income tax assessment, petitioner posits that the insurance claims and gains from insurance claims were directly related to its registered activities. Petitioner also explains that the insurance claims pertained to the recovery of the book value of the assets, the depreciation charges of which were previously amortized and charged to cost of goods manufactured, and the same also with the gains from insurance claims which were the recovery of the net book value of insured assets like buildings, machinery and inventory whose values have been amortized, depreciated and charged versus cost of goods manufactured. Petitioner avers that since both of the afore-mentioned incomes pertained to assets which were used in its PEZA-registered activities, the same should be subject to 5% GIT.

On the other hand, petitioner disputes the deficiency VAT assessment by maintaining that being received not in the regular or ordinary course of petitioner's business, the insurance proceeds should not be subject to VAT, pursuant to Section 105 of the NIRC of 1997, as amended.

Petitioner also relied on BIR Ruling DA-084-07 dated February 12, 2007, which held that:

> "At this juncture, observation has to be made of the fact that although HPI will be indemnified by the insurance companies for the value of the damaged assets, such indemnification cannot be regarded as actual sale of goods by HPI to the insurance companies. The indemnification arises because of the happening of a fortuitous event. Besides, HPI is engaged in the business of manufacturing and supplying cement and not in the sale of cement manufacturing assets. Thus, the insurance proceeds shall not form part of HPI's gross sales for VAT purposes as the

[56] *Commissioner of Internal Revenue vs. Gonzalez, et al.*, G.R. No. 177279, October 13, 2010.

receipt of the insurance proceeds is not in the regular or ordinary course of HPI's business. Accordingly, the insurance proceeds derived by HPI due to the destruction of its insured assets shall not form part of its gross sales for VAT purposes."

Section 105 of the Tax Code states:

"SEC. 105. *Persons Liable.* – Any person who, in the course of trade or business, sells barters, exchanges, leases goods or properties, renders services, and any person who imports goods shall be subject to the value-added tax (VAT) imposed in Sections 106 to 108 of this Code.

The value-added tax is an indirect tax and the amount of tax may be shifted or passed on to the buyer, transferee or lessee of the goods, properties or services. This rule shall likewise apply to existing contracts of sale or lease of goods, properties or services at the time of the effectivity of Republic Act No. 7716.

The phrase '*in the course of trade or business*' means the regular conduct or pursuit of a commercial or an economic activity, including transactions incidental thereto, by any person regardless of whether or not the person engaged therein is a nonstock, nonprofit private organization (irrespective of the disposition of its net income and whether or not it sells exclusively to members or their guests), or government entity.

xxx xxx xxx"

In the case of *CS Garments, Inc. vs. Commissioner of Internal Revenue*[57], the Court of Tax Appeals *En Banc* defined the phrase "in the course of trade or business", as follows:

"xxx A transaction will be characterized as having been entered into by a person in the course of trade or business if it is: (1) regularly conducted; and (2) undertaken in pursuit of a commercial or economic activity. Likewise, transactions that are made incidental to the pursuit of a commercial or economic activity are considered as entered into in the course of trade or business. 'Incidental' means something else as primary; something necessary, appertaining to, or depending upon another, which is termed the principal. Hence, an isolated transaction is

[57] CTA EB No. 287, January 14, 2008.

not necessarily disqualified from being made incidentally in the course of trade or business.

xxx xxx xxx

Once an activity has been identified as a business, any supply [sale] made while carrying it on is likely to be made in the course or furtherance of business. No distinction is made between capital and revenue items. Thus, a supply [sale] in the course or furtherance of business includes: (1) *the disposition of the assets and liabilities of a business*; (2) the disposition of a business as going concern; and (3) anything done in connection with the termination or intended termination of a business."

As stated earlier, petitioner failed to present the details of its PEZA registration. Be that as it may, the insurance claims (₱30,000,00) and gains from insurance claims (₱6,638,883.00) are not the results of petitioner's pursuance of its SEC-registered business activities, nor are they incidental thereto, but instead, represent indemnifications for the unexpected loss of assets. The said insurance claims and gain therefrom would not have turned up had a fortuitous event or casualty loss not occurred in petitioner's premises, in which case, the intention to pursue a form of business opportunity is absent. Hence, these insurance claims cannot in any way be considered to have been received in the ordinary course of petitioner's SEC-registered business activities. Accordingly, these insurance claims cannot also be considered to have been received in the ordinary course of petitioner's PEZA-registered manufacturing activity and therefore should not be subjected to 5% GIT.

Since petitioner derived income or profit from its insurance claims totalling ₱6,668,883.00, the same shall be subject to 35% deficiency income tax pursuant to Section 27(a) in relation to Section 32(a) of the Tax Code.

With regard to the 12% deficiency VAT assessment on the said insurance claims, the same should be cancelled or withdrawn as the indemnification was neither a sale of goods or services nor an incidental transaction subject to VAT under Sections 106, 108 nor 105 of the Tax Code.

In sum, the Court sustains respondent's basic deficiency income tax assessment against petitioner for taxable year 2006 in the amount of ₱2,045,393.42, computed as follows:

Deficiency Income Tax	**35%**	**5%**
Taxable net income per audit	₱6,788,883.00	₱15,066,367.46
Income Tax due	2,376,109.05	753,318.37
Total Income Tax due		3,129,427.42

Less: Tax paid		1,084,034.00
Basic Deficiency Income Tax Due		**₱2,045,393.42**

II. Deficiency Value-added Tax (₱1,963,561.30)

Respondent arrived at the deficiency VAT assessment in the amount of ₱1,963,561.30 as follows:[58]

Taxable receipts per audit	₱ 6,962,983.33
VAT due	835,558.00
25% Surcharge	208,889.50
20% Interest p.a.	919,113.80
TOTAL AMOUNT DUE AND COLLECTIBLE	**₱1,963,561.30**

Further, respondent considered the following items of income as VAT taxable receipts of petitioner pursuant to Section 108 of the NIRC of 1997, as amended, thus:[59]

Other Operating Income	₱ 150,000.00
Miscellaneous income	6,812,983.33
Total	**₱6,962,983.33**

It should be noted that the Other Operating Income per Note 1, Annex "C" of the FLD[60] referred to rent income of ₱120,000.00 plus insurance claims of ₱30,000.00.

According to petitioner, the Miscellaneous Income in the amount of ₱6,812,983.33, upon which respondent imposed 12% deficiency VAT, was allegedly composed of the following:[61]

Gain from insurance claim	₱ 6,638,883.33
Interest on bond with PNB	18,300.00
Dividend Income	5,800.00
Insurance claims	30,000.00
Canteen rental	120,000.00
Total	**₱6,812,983.33**

From the above breakdown, it appears that rental in the amount of ₱120,000.00 and insurance claims in the amount of ₱30,000.00 under Other Operating Income were already included in the Miscellaneous Income. Hence,

[58] Exhibit "C", *Docket*, p. 57; Exhibit "12", BIR records, p. 472.
[59] Exhibit "C", *Docket*, p. 63; Exhibit "12", BIR records, p. 466.
[60] Exhibit "C", *Docket*, p. 62; Exhibit "12", BIR records, p. 467.
[61] Exhibit "D", *Docket*, p. 1082.

the deficiency VAT assessment on the Other Operating Income of ₱150,000.00 shall be cancelled.

The Court shall now determine the merits of the deficiency VAT assessment on the Miscellaneous Income of ₱6,812,983.33.

As stated earlier, since petitioner did not present before the Court the details of its registration with the PEZA, the Court cannot ascertain whether commercial leasing is part of its registered activities. Consequently, the deficiency VAT assessment on the rental income in the amount of ₱120,000.00 should be upheld pursuant to Section 108(a) of the Tax Code.

However, with respect to the insurance claims and the gain therefrom in the amounts of ₱30,000.00 and ₱6,638,883.33, respectively, the same do not pertain to a sale of goods or services or incidental transactions subject to VAT under Sections 105, 106 or 108 of the Tax Code.

The Court has already ruled earlier that since the said insurance claims were mere indemnifications for the unexpected loss of assets, the same shall not be subjected to VAT.

Likewise, the deficiency VAT assessment on the dividend income in the amount of ₱5,800.00 and insurance bond with the Philippine National Bank (PNB) in the amount of ₱18,300.00 should be cancelled. Pursuant to Sections 106 and 108 of the Tax Code, VAT is imposed upon a sale of goods or properties, sale of services or use/lease of properties. Since the said dividend income and insurance bond do not pertain to any of the transactions subject to VAT, the related deficiency VAT assessment should be cancelled and withdrawn.

In fine, petitioner is liable for basic deficiency VAT in the amount of ₱14,400.00, computed as follows:

Canteen Rental	₱ 120,000.00
VAT rate	12%
Basic Deficiency VAT	**₱14,400.00**

III. Expanded Withholding Tax (₱8,827.83)

Invoking Section (57)(b) of the Tax Code and RR 02-98, respondent assessed petitioner for under-remitted EWT in the amount of ₱8,827.83, inclusive of interest, computed as follows:[62]

[62] Exhibit "C", *Docket*, p. 57; Exhibit "12", BIR records, p. 472.

Expanded withholding tax due	₱279,168.59
Less: Remittance	274,964.86
Balance	4,203.73
20% Interest p.a.	4,624.10
TOTAL AMOUNT DUE AND COLLECTIBLE	**₱ 8,827.83**

Based on the FLD[63], petitioner has basic deficiency EWT of ₱4,203.73, broken down as follows:

	Amount	EWT Rate	Tax Due
FO-Rental	₱ 714,295.63	5%	₱ 35,714.78
FO-Freight & Delivery	72,954.49	10%	7,295.45
FO-Repairs	1,231,047.89	2%	24,620.96
Rental	4,079,559.52	5%	203,977.98
Repairs and Maintenance	212,378.59	2%	4,247.57
Advertising	26,687.73	2%	533.75
Documentation and Handling	27,780.97	10%	2,778.10
EWT due per BIR			279,168.59
EWT Paid			274,964.86
Balance			**₱4,203.73**

Petitioner insists that respondent included in the computation items which are not subject to withholding and explains them in the following manner:[64]

a. **Repairs and Maintenance (₱212,378.59)** – According to petitioner, the repairs were done by petitioner's employee and the amounts disbursed represented the cost of building materials and machinery parts. Petitioner avers that it cannot withhold tax from itself.

b. **Advertising (₱26,687.73)** – Petitioner explains that these advertising expenses were actually solicitation of individuals and not by an advertising firm.

c. **Documentation and Handling (₱27,780.00)** – This expense allegedly represents petitioner's share in documentation and handling which was billed to them by another PEZA-registered company. According to petitioner, this account also includes small items disbursed from the company's petty cash fund.

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[63] Exhibit "C", *Docket*, p. 64; Exhibit "12", BIR records, p. 465.
[64] Memorandum (For Petitioner), *Docket*, p. 1536; Exhibit "D", *Docket*, pp. 1082 to 1083.

To prove its allegations, petitioner presented a reconciliation of the deficiency EWT assessment, detailed as follows:[65]

	PER BIR COMPUTATIONS			PER MEDTECS COMPUTATIONS		
	Gross Amount	**Rate**	**EWT**	**Gross Amount**	**Rate**	**EWT**
FO-Rental	₱ 714,295.63	5%	₱35,714.78	₱ 714,295.63	5%	₱ 35,714.78
FO-Freight and Delivery	72,954.49	10%	7,295.45	72,954.49	2%	1,459.09
FO-Repairs	1,231,047.89	2%	24,620.96	1,231,047.89	2%	24,620.96
Rental	4,079,559.52	5%	203,977.98	4,079,559.52	5%	203,977.98
Repairs and Maintenance	212,378.59	2%	4,247.57	212,378.59	2%	4,247.57
Advertising	26,687.73	2%	533.75	26,687.73	2%	533.75
Documentation and Handling	27,780.97	10%	2,778.10	27,780.97	10%	2,778.10
EWT due per BIR			279,168.59			273,332.23
EWT Paid			274,964.86			274,964.86
Deficiency Withholding Tax			**4,203.73**			**₱ (1,632.63)**
Interest			4,624.10			
Total			**₱8,827.83**			

Based on the reconciliation, the Court finds that the discrepancy came from FO-Freight and Delivery in the amount of ₱72,954.49 which respondent subjected to 10% EWT, whereas petitioner subjected the same to 2%. The latter actually resulted in overpayment of EWT in the amount of ₱1,632.63.

Under Section 2.57.2(E)(4)(e) of RR 02-98, as amended by RR 30-03, transportation contractors, which include common carriers of goods and merchandise, are subject to 2% EWT, thus:

> "SECTION 2.57.2. *Income Payment Subject to Creditable Withholding Tax and Rates Prescribed Thereon.* – Except as herein otherwise provided, there shall be withheld a creditable income tax at the rates herein specified for each class of payee from the following items of income payments to persons residing in the Philippines:
>
> xxx xxx xxx
>
> (E) *Income payments to certain contractors.* – On gross payments to the following contractors, whether individual or corporate — **Two percent (2%).**
>
> xxx xxx xxx
>
> (4) *Other contractors.* –

[65] Exhibit "M", *Docket*, p. 1188.

xxx xxx xxx

> (e) Transportation contractors which include **common carriers for carriage of goods and merchandise of whatever kind by land, air or water**, where the gross payments by the payor to the same payee amounts to at least two thousand pesos (₱2000) per month, regardless of the number of shipments during the month;" *(Emphasis supplied)*

Based on the afore-quoted provision, only 2% EWT should be imposed to providers of freight services and not 10%. Thus, the deficiency expanded withholding tax assessment in the amount of ₱8,827.83 should be cancelled.

IV. Withholding Tax on Compensation (₱419,059.88)

Upon respondent's verification, she found that salaries and wages amounting to ₱3,941,001.91 were not subjected to withholding tax, in violation of Sections 78 and 79 of the Tax Code, and as implemented by RR 02-98. As a consequence, respondent assessed petitioner of deficiency withholding tax on compensation amounting to ₱419,059.88, inclusive of interest, computed as follows:[66]

Withholding Tax due on Compensation	₱3,024,551.55
Less: Remittance	2,827,501.45
Balance	**197,050.10**
20% Interest p.a.	222,009.78
Total Amount Due and Collectible	**₱419,059.88**

A detailed computation of the basic deficiency WTC in the amount of ₱197,050.10 can be found in Annex "G" of the FLD[67], as shown below:

	13th Month	**SSS, PHIC, etc.**	**Salaries and other forms of compensation**	**Total**
Schedule 7.1	₱ 221,256.25	₱ 130,259.00	₱ 3,770,830.83	₱ 4,122,346.08
Schedule 7.2	1,786.32	12,403.50	216,984.69	231,174.51
Schedule 7.3	1,316,100.02	740,340.20	17,279,471.11	19,335,911.33
Schedule 7.4	23,226.67	5,191.70	202,869.33	231,287.70
Total	1,562,369.26	888,194.40	21,470,155.96	23,920,719.62
Less: Compensation per FS				
Direct Labor				7,275,617.59

[66] Exhibit "C", *Docket*, p. 57; Exhibit "12", BIR records, p. 472.
[67] Exhibit "C", *Docket*, p. 65; Exhibit "12", BIR records, p. 464.

FO-Salaries and wages				3,611,908.97
FO-Overtime pay				101,548.00
FO-Holidays				50,769.00
FO-Bonus &13th month				107,946.91
FO-Other Employee Benefits				371,198.00
FO Subsistence				5,148.40
Salaries				13,732,169.42
Wages Overtime Pay				419,842.48
Holiday Pay				2,496.41
13th month Pay				1,257,082.26
Subsistence				2,036.75
Other Employee benefits				895,738.87
GA Employee benefits				28,218.47
Salaries and wages not subject to withholding tax				**3,941,001.91**
Multiply by 5% minimum rate				0.05
Withholding tax due				197,050.10
Add w/tax due from alphalist				2,827,501.45
Total				3,024,551.55
Less Paid				2,827,501.45
Balance				**₱ 197,050.10**

Petitioner claims that the assessment on deficiency withholding tax on compensation has no basis. It is alleged that the total amount of compensation per Alphalist is lower than the total amount of compensation per Financial Statement since some items reported in the Financial Statements are not required to be reported in the Alphalist.

Section 2.79(B)(3) of RR 2-98 provides the guidelines in computing the withholding tax on compensation income, to wit:

> "SECTION 2.79. *Income Tax Collected at Source on Compensation Income.*
>
> xxx xxx xxx
>
> (B) *Computation of Withholding Tax on Compensation Income in General.* – The procedures provided herein below shall govern the computation of withholding tax on the taxable compensation income of the employees. Provided, however, That taxable fringe benefits received by employees other than the rank and file, as defined in the Labor Code of the Philippines, as amended, shall be subject to a Fringe Benefits Tax, instead of the rates prescribed in the Withholding Tax Tables pursuant to Sec. 24(A) of the Code, as amended (refer to Sec. 2.79.D of these Regulations).
>
> xxx xxx xxx
>
> (3) *Steps to determine the amount of tax to be withheld:*

Step 1. Use the appropriate tables for the payroll period; monthly semi-monthly weekly or daily as the case may be.

Step 2. Determine the total monetary and non-monetary compensation paid to an employee for the payroll period, segregating gross benefits which includes thirteenth (13th) month pay, productivity incentives, Christmas bonus, and other benefits received by the employee per payroll period. Gross benefits which are received by officials and employees of public and private entities in the amount of thirty thousand pesos (₱30,000) or less shall be exempted from income tax and from withholding tax.

Step 3. Segregate the taxable compensation from the non-taxable income paid to the employee for the payroll period. The taxable income refers to all remuneration paid to an employee not otherwise exempted by law from income tax and consequently from withholding tax. **The non-taxable income are those which are specifically exempted from income tax by the Code or by other special laws as listed in Sec. 2.78.1 (B) of these Regulations (e.g. benefits not exceeding ₱30,000, non-taxable retirement benefits and separation pay).**" *(Emphasis supplied)*

Based on the above regulations, in order to determine the taxable compensation, the non-taxable compensation should be deducted from the total compensation. This is exactly how BIR Form Nos. 1601-C and 1604-CF and the Alphalists are formatted – there is a separate portion where the non-taxable items should be disclosed.

Further, the Court finds no reason why the SSS (employee's share), Philhealth and Pag-Ibig contributions, other employee benefits, subsistence, and other benefits should not be disclosed in the Alphalists or in the Monthly Remittance Return of Income Taxes Withheld on Compensation (BIR Form No. 1601-C) or in the Annual Information Return of Income Taxes Withheld on Compensation and Final Withholding Taxes (BIR Form No. 1604-CF), when these returns have a specific line item for non-taxable compensation so that taxpayers can properly disclose the non-taxable benefits they provide to employees.

The Court shall now proceed to scrutinize the items composing the deficiency WTC.

1. Portion of Direct Labor pertaining to (a) DL-SSS, DL-Medicare, DL-Pag-ibig and (b) DL-Other Employee Benefits[68]

The Direct Labor of ₱7,275,617.59 allegedly consisted of the following:

DL-Salaries and wages	₱ 4,887,059.18
DL-Overtime pay	84,575.78
DL-Holiday	170,100.48
DL-Bonus and 13th Month Pay	482,241.43
DL-SSS	315,740.90
DL-Medicare	57,037.50
DL-Pag-ibig	73,346.36
DL-Retirement	68,137.08
DL-Other Employee Benefits	1,137,378.88
Total	**₱7,275,617.59**

(a) ***On DL-SSS (₱315,740.90), DL-Medicare (₱57,037.50) and DL-Pag-ibig (₱73,346.36).*** These items are allegedly employer's contributions to SSS, Medicare and Pag-IBIG which are not required to be reported in the alphalist and are exempt from withholding tax on compensation under Section 32(B)(7)(f) of the Tax Code.[69]

Section 32(B)(7)(f) of the Tax Code, explicitly states:

"SEC. 32. *Gross Income.* –

xxx xxx xxx

(B) *Exclusions from Gross Income.* – The following items shall not be included in gross income and shall be exempt from taxation under this Title:

xxx xxx xxx

(7) *Miscellaneous Items.* –

xxx xxx xxx

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[68] Memorandum (For Petitioner), *Docket*, p. 1537; Exhibit "P", *Docket*, pp. 1331 to 1333; Exhibit "D", *Docket*, p. 1084.

[69] Memorandum (For Petitioner), *Docket*, p. 1537; Exhibit "P", *Docket*, p. 1331; Exhibit "D", *Docket*, p. 1084.

> (f) *GSIS, SSS, Medicare and Other Contributions.* –GSIS, SSS, Medicare and Pag-ibig contributions, and union dues of individuals."

Indeed, contributions remitted to SSS, Medicare (Philhealth) and Pag-ibig are excluded from the computation of the employee's taxable income, thus, not subject to WTC.

To support these expenses, petitioner presented Exhibits "N-9"[70], "N-10"[71] and "N-11"[72], comprising of accounts payable vouchers, SSS special bank receipts, Philhealth official receipts, machine validated Philhealth Contributions Payment Returns, and Pag-Ibig Fund receipts.

The Court notes that there was no proof of payment for the month of August, leaving a properly supported amount of ₱288,921.20, representing SSS contribution attributable to Direct Labor (DL), as shown below:

Total SSS Premium Payments (Exhibit "N")	₱ 315,657.60
Less: Unsupported SSS Premiums for August (Exhibit "N", APV2682)	26,736.40
Properly Supported SSS Premiums for 2006	**₱288,921.20**

Likewise, no evidence was presented to prove that Pag-Ibig contributions were paid for the month of September, thus, substantiating only the amount of ₱66,300.00, as computed below:

Total Pag-ibig Premiums (Exhibit "N")	₱ 72,700.00
Less: Pag-ibig Premiums for September (Exhibit "N" under APV2711)	6,400.00
Properly Supported Pag-ibig Premiums	**₱66,300.00**

As regards the DL-Medicare, the supporting documents submitted by petitioner, marked as Exhibit "N-10", are found to be in order.

The Court finds that even though petitioner failed to disclose these items in the withholding tax returns, there will be no effect to the deficiency withholding tax assessment because these are non-taxable. However, since petitioner was not able to present any proof showing payment of SSS and Pag-ibig Contributions for the months of August and September, respectively, out of the total amount of ₱446,124.76 representing the mandatory contributions

[70] *Docket*, pp. 1242 to 1263.
[71] *Id.*, pp. 1264 to 1287.
[72] *Id.*, pp. 1288 to 1309.

attributable to direct labor, only the amount of ₱412,258.70 has been substantiated,[73] detailed as follows:

SSS Premiums	₱ 288,921.20
Philhealth/Medicare Premiums	57,037.50
Pag-ibig Premiums	66,300.00
Total	**₱412,258.70**

Thus, the assessment on deficiency WTC amounting to ₱412,258.70 should be cancelled.

(b) ***On DL-Other Employee Benefits (₱1,137,378.88).*** Petitioner asserts that the DL-Other Employee Benefits of ₱1,137,378.88 consisted of "de minimis" benefits such as groceries for Christmas celebration, uniforms, birthday cakes, and gifts given to employees under the manufacturing department. Such benefits are allegedly not required to be reflected in the alphalist and are exempt from withholding tax pursuant to Section 2.33(C)(4) of RR 03-98.[74]

2. FO-Other Employee Benefits (₱371,198.00); FO-Subsistence (₱5,148.40); Subsistence (₱2,036.75); Other Employee Benefits (₱895,738.87); and GA Employee Benefits (₱28,218.47).

Other Employee Benefits allegedly consist of non-taxable expenses such as groceries for Christmas celebration, uniforms, birthday cakes, and gifts to employees other than those belonging to the manufacturing department, which are not required to be reflected in the alphalist and are exempt from withholding tax under Section 2.33(C)(4) of RR 03-98, which provides as follows:

> "SEC. 2.33. SPECIAL TREATMENT OF FRINGE BENEFITS
>
> xxx xxx xxx
>
> (C) *Fringe Benefits Not Subject to Fringe Benefits Tax* – In general, the fringe benefits tax shall not be imposed on the following fringe benefits:
>
> xxx xxx xxx

[73] The sum of ₱288,921.20 (SSS Premiums), ₱57,037.50 (Philhealth/Medicare Premiums) and ₱66,300.00 (Pag-ibig Premiums).

[74] Memorandum (For Petitioner), *Docket*, p. 1538; Exhibit "P", *Docket*, p. 1332; Exhibit "D", *Docket*, p. 1084.

(4) De minimis benefits as defined in these Regulations;"

To prove its claim, petitioner presented Exhibits "N-2" and "N-3" (reward for employee's perfect attendance), Exhibit "N-4"[75] (payments for employees' birthday cakes), Exhibit "N-5"[76] (expense for the annual excursion), Exhibit "N-6"[77] (catering expenses incurred during the annual Christmas party), and Exhibit "N-8"[78] (cash gift to loyalty awardees). These are summarized below:

Expense	Recorded under	Amount	
Perfect Attendance (Exhs. "N-2" and "N-3")	January 2006	2,800.00	
	February 2006	4,800.00	
	March 2006	5,800.00	
	April 2006	5,800.00	
	May 2006	3,200.00	
	June 2006	5,200.00	
	July 2006	5,600.00	
	August 2006	4,400.00	
	September 2006	5,000.00	
	October 2006	1,600.00	
	November 2006	4,600.00	
	December 2006	5,000.00	53,800.00
Birthday Cakes (Exh. "N-4")	Other Employee Benefits		
	January 2006 - APV No. 2355	508.73	
	February 2006 – APV No. 2392	508.73	
	March 2006 – APV No. 2433	518.70	
	May 2006 – APV No. 2522	432.25	
	August 2006 – APV No. 2643	691.60	2,660.01
	DL-Other Employee Benefits		
	July 2006 – APV No. 2611	432.25	
	September 2006 – APV No. 2674	192.00	
	October 2006 – APV No. 2710	288.00	
	November 2006 – APV No. 2748	864.00	
	December 2006 – APV No. 2791	672.00	2,448.25
	FO-Other Employee Benefits		
	September 2006 – APV No. 2674	288.00	
	October 2006 – APV No. 2710	192.00	
	November 2006 – APV No. 2748	96.00	
	December 2006 – APV No. 2791	288.00	864.00
Annual Excursion (Exh. "N-5")	Other Accrued Expenses – APV No. 2482		24,000.00
Annual Christmas Party Catering (Exh. "N-6")	Prepaid Expenses – APV No. 16728 with attached Provisional Receipts		64,960.00
Loyalty Award	Other Employee Benefits – APV Nos. 16776		25,000.00

[75] *Docket*, pp. 1222 to 1231.
[76] *Id.*, p. 1232.
[77] *Id.*, p. 1233 to 1234.
[78] *Id.*, pp. 1237 to 1241.

(Exh. "N-8")	to 16780 (₱5,000 x 5)		
TOTAL			₱173,732.26

However, petitioner submitted only the AP vouchers or mere listing of benefits granted instead of official receipts or invoices from suppliers and proofs of payment of the benefits to petitioner's employees. Only the payment for annual Christmas party catering for the employees was substantiated by petitioner in the amount of ₱64,960.00.

As a result, only the amount of ₱64,960.00 representing annual Christmas party catering for petitioner's employees can be considered *de minimis* benefits exempt from tax pursuant to Section 2.33(C)(4) of RR 03-98. Accordingly, only the deficiency WTC in the amount of ₱64,960.00 shall be cancelled.

Anent petitioner's claimed deduction for DL-Retirement in the amount of ₱68,137.08[79] and Other Employees Benefits – Retirement in the amount of ₱739,967.67[80], petitioner presented journal vouchers[81] establishing that these amounts were mere provisions/accruals for future payment of retirement benefits.

As can be seen in Note 13[82] of petitioner's Audited Financial Statements for calendar year 2006, such accrued retirement benefits were based on an unfunded, non-contributory pension plan covering substantially all of petitioner's regular employees.

Section 2.79(A) of RR 2-98, as amended, requires every employer to withhold tax from compensation paid.

Since the amount of ₱808,104.75 (the sum of ₱68,137.08 DL-Retirement and ₱739,967.67 Other Employees Benefits – Retirement) refers to the accrued retirement expenses, petitioner is not yet required to withhold tax on compensation. Thus, the deficiency WTC in the amount of ₱808,104.75 should be cancelled.

Considering the foregoing, petitioner is liable for basic deficiency withholding tax in the amount of ₱132,783.92, computed as follows:

[79] Exhibit "D", *Docket*, p. 1084.
[80] Exhibit "N", *Docket*, p. 1189.
[81] Exhibit "N-1", *Docket*, pp. 1191 to 1202.
[82] BIR records, p. 56.

	13th Month	SSS, PHIC, etc.	Salaries and other forms of compensation	Total
Schedule 7.1	₱ 221,256.25	₱ 130,259.00	₱ 3,770,830.83	₱ 4,122,346.08
Schedule 7.2	1,786.32	12,403.50	216,984.69	231,174.51
Schedule 7.3	1,316,100.02	740,340.20	17,279,471.11	19,335,911.33
Schedule 7.4	23,226.67	5,191.70	202,869.33	231,287.70
Total	**₱1,562,369.26**	**₱888,194.40**	**₱21,470,155.96**	**₱23,920,719.62**
Less: Compensation per FS				
Direct Labor				₱ 7,275,617.59
Less: DL-SSS, DL-Medicare, DL-Pag-ibig duly supported by petitioner				(412,258.70)
Less: DL-Retirement Expense				(68,137.08)
FO-Salaries and wages				3,611,908.97
FO-Overtime pay				101,548.00
FO-Holidays				50,769.00
FO-Bonus &13th month				107,946.91
FO-Other Employee Benefits				371,198.00
FO Subsistence				5,148.40
Salaries				13,732,169.42
Wages Overtime Pay				419,842.48
Holiday Pay				2,496.41
13th month Pay				1,257,082.26
Subsistence				2,036.75
Other Employee benefits				895,738.87
Less: Annual Christmas party catering				(64,960.00)
Less: Accrued Retirement Expense				(739,967.67)
GA Employee benefits				28,218.47
Total Compensation per FS subject to WTC				**₱26,576,398.08**
Salaries and wages not subjected to withholding tax, per this Court's verification				**₱ 2,655,678.46**
Multiply by 5% minimum rate				5%
Basic Deficiency WTC				**₱ 132,783.92**

V. Documentary Stamp Tax (₱3,752,267.98)

Based on the Details of Discrepancies, respondent found that Stock Options in the amount of ₱243,113,355.06 and Lease Contracts in the amount of ₱381,141,470.28 are subject to documentary stamp tax, pursuant to Sections 174 and 194 of the Tax Code, respectively. Thus, respondent assessed petitioner in the amount of ₱3,752,267.99, representing deficiency DST, inclusive of surcharges and penalties, computed as follows:[83]

[83] Exhibit "C", *Docket*, pp. 57 and 59.

Documentary Stamp Tax	₱ 1,596,709.78
25% Surcharge	399,177.45
20% Interest p.a.	1,756,380.76
Total Amount Due and Collectible	**₱3,752,267.99**

Respondent computed the basic deficiency DST assessment of ₱1,596,709.78 as follows:[84]

	Tax Base	DST
Stock Options	₱243,113,355.06	₱ 1,215,566.78
Lease Contract	381,141,470.28	381,143.00
Total		**₱1,596,709.78**

A. Stock Options (₱1,215,566.78)

Respondent's assessment on stock options in the amount of ₱243,113,355.06[85] was based on Section 174 of the Tax Code, which reads as follows:

> "SEC. 174. *Stamp Tax on Original Issue of Shares of Stock.* – On every original issue, whether on organization, reorganization or for any lawful purpose, of shares of stocks by any association, company or corporation, there shall be collected a documentary stamp tax of One peso (₱1.00) on each Two hundred pesos (₱200), or fractional part thereof, of the par value, of such shares of stock: *Provided*, That in the case of the original issue of shares of stock without par value, the amount of the documentary stamp tax herein prescribed shall be based upon the actual consideration for the issuance of such shares of stock: *Provided, further*, That in the case of stock dividends, on the actual value represented by each share."

Revenue Memorandum Circular (RMC) No. 79-2014, which clarified the tax treatment of Stock Option Plans and Other Option Plans, defined "stock options" as follows:

> "A stock option is an option granted by a person, natural or juridical, to a person or entity entitling said person or entity to purchase shares of stocks of a corporation, which may or may not be the shares of stock of the grantor itself, at a specific price to be exercised at a specific date or period (hereinafter referred to as 'Equity-settlement Option'). It may also occur even if no actual

[84] *Id.*, p. 66.
[85] BIR Records, p. 31; Converted to Philippine Pesos by multiplying by ₱51.33 per respondent's computation found in BIR Records, p. 366.

shares of stocks are transferred in a situation wherein a person or entity is given the right to obtain the difference between the actual fair market value of a share and the fixed nominal value of the shares of stock set in the grant of the option, at a specific date or period, although no actual shares of stocks are transferred (hereinafter referred to as 'Cash-settlement Option'). The grant, sale, transfer, or exercise of the option may result to taxable events.

Stock option are 'shares of stocks' as defined by Section 22 (L) of the National Internal Revenue Code of 1997, as amended, and are taxable as such."

Corollary to this, Section 22(L) of the Tax Code defines "shares of stock" as follows:

"(L) The term '*shares of stock*' shall include shares of stock of a corporation, warrants and/or options to purchase shares of stock, as well as units of participation in a partnership (except general professional partnerships), joint stock of companies, joint accounts, joint ventures taxable as corporations, associations, and recreation or amusement clubs (such as golf, polo or similar clubs), and mutual fund certificates."

The Court finds that the issuance of stock options by petitioner is tantamount to an original issuance of shares of stock that is subject to DST pursuant to Section 174 of the Tax Code.

Based on the Audited Financial Statements, certain key management personnel of the Branch (herein petitioner) received share options granted by its Parent Company. The employees were granted 300,000 and 50,000 share options in 2006 and 2005, respectively, which are exercisable one year after the date of grant. The Branch recognized in the Parent Company statement of income the value of employee services on equity-settled stock options of $574 and $3,020 in 2006 and 2005, respectively. The carrying amount of the employee share option included in the "Current account" presented in the "Home office account" section of the balance sheet was $13,071 and $11,348 as of December 31, 2006 and December 31, 2005, respectively.[86]

Respondent computed the stock options subject to DST by taking the "Decrease in current account" in the amount of $4,738,005[87] and deducting the

[86] Exhibit "I", Notes to Parent Company Financial Statements, under Note 14. Share-based Payments, *Docket*, pp. 1124 to 1125.

[87] Exhibit "I", Parent Company Statements of Changes in Home Office Account For The Years Ended December 31, 2006 And 2005, *Docket*, p. 1101.

"Value of employee services – equity-settled stock options" in the amount of $1,723[88] and then multiplying the difference ($4,736,282) by ₱51.33 to get the peso equivalent of ₱243,113,355.06[89]. However, nothing in the records indicates the rationale for respondent's decision to pick up the "Decrease in current account" less the "Value of the employee services – equity-settled stock options" to be subject to DST.

It should be noted that a Branch Current Account in a Home Office Account is a running account between the Branch and the Head Office where all the transactions between the Branch and Head Office are recorded. Therefore, it cannot simply assume that the net movement of the said account for calendar year 2006 is attributable entirely to stock options issuance.

Considering the foregoing, the Court finds it appropriate that the carrying amount of the employee's share option as of December 31, 2005 included in the "Current account" presented in the "Home office account" section of the Balance Sheet, as discussed in Note 14 of petitioner's Audited Financial Statements (*i.e.*, $11,348), be deducted from the carrying amount of said stock options as of December 31, 2006 (*i.e.*, $13,071)[90], in order to get the stock options granted for calendar year 2006 of $1,723. Then this shall be multiplied by ₱51.33 to get its Philippine Peso equivalent of ₱88,441.59, which will result in a basic deficiency DST of ₱442.21.

B. Lease Contract (₱381,143.00)

Respondent's assessment on lease contracts in the amount of ₱381,141,470.28[91] was based on Section 194 of the Tax Code which reads:

> "SEC. 194. *Stamp Tax on Leases and Other Hiring Agreements.* – On each lease, agreement, memorandum, or contract for hire, use or rent of any lands or tenements, or portions thereof, there shall be collected a documentary stamp tax of Three pesos (₱3.00) for the first Two thousand pesos (₱2,000), or fractional part thereof, and an additional One peso (₱1.00) for every One Thousand pesos (₱1,000) or fractional part thereof, in excess of the first Two thousand pesos (₱2,000) for each year of the term of said contract or agreement."

[88] Exhibit "I", Parent Company Statements of Changes in Home Office Account For The Years Ended December 31, 2006 And 2005, *Docket*, p. 1101.
[89] Exhibit "C", *Docket*, p. 66; Exhibit "12", BIR records, p. 463.
[90] Exhibit "I", Notes to Parent Company Financial Statements, under Note 14. Share-based Payments, *Docket*, p. 1125.
[91] Exhibit "C", *Docket*, p. 66.

Petitioner argues that its PEZA-registered status exempts it from DST under Section 24 of RA 7916. This finds support allegedly in *Nidec Copal Phil. Corp. vs. Commissioner of Internal Revenue*[92], the pertinent portion of which states:

> "Petitioner submits that pursuant to *Section 24 of RA No. 7916*, as amended by *RA No. 8748*, it is only liable to the preferential tax rate of 5% on its gross income which shall be in lieu of local and national taxes. Since the 5% preferential tax rate is a commutation of all local and national taxes otherwise due from businesses and enterprises operating within the ecozone, petitioner is exempt from the payment of DST.
>
> We agree with petitioner.
>
> *Section 24 of RA 7916* or the PEZA Law provides:
>
> > '**SEC. 24. Exemption from Taxes Under the National Internal Revenue Code.** – Any provision of existing laws, rules and regulations to the contrary notwithstanding, no taxes, local and national, shall be imposed on business establishments operating within the ECOZONE. In lieu of paying taxes, five percent (5%) of the gross income earned by all businesses and enterprises within the ECOZONE shall be remitted to the national government. xxx.'
>
> Corollary thereto, *Section 1, Rule XX of the PEZA Rules* provides:
>
> > 'RULE XX
> > Gross Income Taxation
> >
> > SECTION 1. Special Tax Rate. – Pursuant to Section 24 of the Act, ECOZONE Enterprises, except ECOZONE Service Enterprises, shall, in lieu of payment of national and local taxes, be liable to the payment of a five per cent (5%) final tax on gross income earned xxx.'
>
> Pursuant to the above provisions, PEZA registered enterprises, like herein petitioner, are only liable to pay 5% tax on gross income earned (GIE) on their registered activities, which is

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[92] CTA Case No. 6577, September 25, 2006.

> in lieu of payment of national and local taxes. The phrase 'in lieu of payment of national and local taxes' means that petitioner, after paying a 5% final tax on GIE, is exempt from payment of local and national taxes which includes the DST imposed under *Section 180 of the NIRC of 1997*."

On the other hand, respondent acknowledged the entitlement of petitioner to the exemption but pointed out that whenever one party to the taxable document enjoys exemption from the tax, the other party who is not exempt shall be the one liable for the tax pursuant to Section 173 of the Tax Code which imposes the collection of DST on documents, instruments, loan agreements and papers to the person making, signing, accepting or transferring the same.[93] Section 173 is quoted hereunder:

> "SEC. 173. *Stamp Taxes Upon Documents, Loan Agreements, Instruments and Papers.* – Upon documents, instruments, loan agreements and papers, and upon acceptances, assignments, sales and transfers of the obligation, right or property incident thereto, there shall be levied, collected and paid for, and in respect of the transaction so had or accomplished, the corresponding documentary stamp taxes prescribed in the following Sections of this Title, by the person making, signing, issuing, accepting, or transferring the same wherever the document is made, signed, issued, accepted or transferred when the obligation or right arises from Philippine sources or the property is situated in the Philippines, and the same time such act is done or transaction had: *Provided,* That **whenever one party to the taxable document enjoys exemption from the tax herein imposed, the other party who is not exempt shall be the one directly liable for the tax.**" *(Emphasis supplied)*

To support its contention, petitioner presented before the Court Exhibit "O"[94], which is the renewal of petitioner's Lease Agreement with the PEZA signed on June 10, 2003. Under the said Lease Agreement, petitioner is the lessee of a 22,646 square meter lot inside the Bataan Economic Zone.

Since it has been established that petitioner is not liable for DST, the DST should have been for the account of the other contracting party, who in this case is the PEZA. However, petitioner failed to show copies of DST returns filed by and payment receipts from the PEZA. Hence, in the absence of contrary evidence, the Court finds that petitioner should be held liable for basic deficiency DST in the amount of ₱381,143.00 on the lease contract entered into by petitioner with PEZA.

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[93] Answer, *Docket*, pp. 734 to 737.
[94] *Docket*, pp. 1310 to 1314.

In sum, petitioner is liable for basic deficiency DST in the amount of ₱381,585.21, computed as follows:

	Tax Base	DST
Stock Options	₱ 88,441.59	₱ 442.21
Lease Contract	₱381,141,470.28	₱ 381,143.00
Total Basic Deficiency DST		**₱381,585.21**

VI. Compromise Penalties (₱162,000.00)

Respondent imposed compromise penalties against petitioner totalling ₱162,000.00, broken down as follows:

Compromise penalty imposed on deficiency income tax	₱ 50,000.00
Compromise penalty imposed on deficiency VAT	20,000.00
Compromise penalty imposed on deficiency WTC	1,000.00
Compromise penalty imposed on deficiency EWT	16,000.00
Compromise penalty imposed on deficiency DST	75,000.00
Total	**₱162,000.00**

Pursuant to Revenue Memorandum Order (RMO) No. 01-90, as amended by RMO 19-07, compromise penalties are only suggested in settlement of criminal liability, and may not be imposed or exacted on the taxpayer in the event that a taxpayer refuses to pay the same. Clearly, the compromise penalty implies a mutual agreement between the parties in respect to the thing or subject matter which is so compromised. The imposition of the compromise penalty without the conformity of the taxpayer is illegal and unauthorized.[95] And there is nothing in the records which would show that petitioner consented to the compromise penalty. Therefore, the compromise penalty should not be imposed and must be cancelled.

WHEREFORE, premises considered, the instant Petition for Review is hereby **PARTIALLY GRANTED**. Accordingly, the assessments issued by respondent against petitioner for taxable year 2006 covering deficiency expanded withholding tax in the amount of ₱8,827.83 and compromise penalties in the amount of ₱162,000.00 are **CANCELLED AND WITHDRAWN**. However, the assessments of deficiency income tax, value-added tax, withholding tax on compensation, and documentary stamp tax are **AFFIRMED WITH MODIFICATIONS**.

Consequently, petitioner is **ORDERED TO PAY FIVE MILLION THREE HUNDRED NINETY SEVEN THOUSAND FIVE**

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[95] *Commissioner of Internal Revenue vs. Lianga Bay Lagging Co., Inc., et al.*, G.R. No. L-35266, January 21, 1991.

HUNDRED EIGHTY EIGHT PESOS AND TWENTY THREE CENTAVOS (₱5,397,588.23) representing deficiency income tax, value-added tax, withholding tax on compensation, and documentary stamp tax for taxable year 2006, inclusive of the twenty-five percent (25%) surcharge and twenty percent (20%) deficiency interest imposed under Sections 248(A)(3) and 249(B) of the NIRC of 1997, as amended, computed as follows:

Deficiency Tax	Basic Tax	25% Surcharge	20% Deficiency Interest[96]	Total
Income Tax	₱ 2,045,393.42	₱ 511,348.36	₱ 2,179,885.04	₱ 4,736,626.82
Value-added Tax	14,400.00	3,600.00		18,000.00
Withholding Tax on Compensation	132,783.92	33,195.98		165,979.90
Documentary Stamp Tax	381,585.21	95,396.30		476,981.51
Total	**₱ 2,574,162.55**	**₱ 643,540.64**	**₱ 2,179,885.04**	**₱ 5,397,588.23**

In addition, petitioner is **ORDERED TO PAY** delinquency interest at the rate of 20% per annum on the total amount of **₱5,397,588.23** computed from August 11, 2012 until full payment thereof pursuant to Section 249(C) of the NIRC of 1997, as amended.

SO ORDERED.

Ma. Belen S. L.

MA. BELEN M. RINGPIS-LIBAN
Associate Justice

WE CONCUR:

LOVELL R. BAUTISTA
Associate Justice

ESPERANZA R. FABON-VICTORINO
Associate Justice

[96] Computed based on the basic deficiency income tax of ₱2,045,393.42 from April 15, 2007 until August 11, 2012.

ATTESTATION

I attest that the conclusions in the above decision were reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

LOVELL R. BAUTISTA
Associate Justice
Chairperson

CERTIFICATION

Pursuant to Section 13 of Article VIII of the Constitution, and the Division's Chairperson's Attestation, it is hereby certified that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

ROMAN G. DEL ROSARIO
Presiding Justice